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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

No. 93-823

NEBRASKA DEPARTMENT OF REVENUE,
Petitioner,

v.

JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to The Supreme Court of Nebraska

BRIEF OF THE INVESTMENT COMPANY INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

The Investment Company Institute submits this brief as *amicus curiae* in support of respondent in this case. All parties have provided written consent to the filing of this brief. Letters of consent have been lodged with the Clerk.

INTEREST OF AMICUS CURIAE

The Investment Company Institute is the national association of the American investment company industry. Its membership includes open-end investment companies (commonly known as "mutual funds"), closed-end investment companies, investment advis-

ers, and principal underwriters and sponsors of unit investment trusts. The Institute's investment company members are registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, and are subject to detailed statutory and regulatory prescriptions regarding their structure, operations, and governance.

One of the Institute's main objectives is to ensure adequate legal protection of investment companies and their shareholders. In pursuit of this goal, the Institute regularly engages in legislative and private-sector initiatives aimed at increasing government and public awareness of issues affecting investment companies. The Institute has frequently appeared before this Court as *amicus curiae*, most recently in *Kamen v. Kemper Financial Services, Inc.*, No. 90-516, 111 S.Ct. 1711 (1991).

The Institute has a twofold interest in this case. Its principal concern is to ensure that the Court's disposition does not incidentally affect settled rules of mutual fund taxation that are not implicated here. It is firmly established that a mutual fund's distribution to its shareholders of income attributable to the fund's investments in U.S. government obligations is exempt from state taxation under 31 U.S.C. § 3124(a) and the Supremacy Clause. The Institute has a strong interest in ensuring that this basic precept of constitutional law is not compromised in this case.

The Institute, its members, and their shareholders likewise are concerned with the narrow question presented here—whether interest received on repurchase agreements involving federal securities is exempt from state tax. Many of the Institute's members hold re-

purchase agreements, and many mutual funds seek to offer their shareholders the opportunity to earn investment income that is wholly or largely exempt from state tax. The Court's opinion may affect mutual funds' decisions about what assets to invest in, as well as the tax treatment of dividends that mutual fund shareholders receive from their funds.

SUMMARY OF ARGUMENT

This is not a case about taxation of mutual funds or their shareholders. Nebraska concedes in this Court that mutual fund dividends are exempt from state tax to the extent they are attributable to federal interest received by the fund from investments in U.S. government obligations. Nebraska's concession in this respect is mandated by this Court's decision in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983), which forbids any "direct or indirect" state taxation of federal obligations or the interest thereon. The exempt status of mutual fund dividends paid out of exempt federal interest is recognized by all states that impose an individual income tax, including Nebraska.

Rather, Nebraska's challenge is confined solely to whether a particular species of income—namely, interest received by investors pursuant to repurchase agreements ("repos") involving federal obligations—constitutes federal interest that is exempt from state taxation under the Supremacy Clause and 31 U.S.C. § 3124. It is irrelevant that a mutual fund happens to have been the investor that initially received the repo interest; precisely the same question would arise if respondent himself had entered into the repo transaction and received that interest directly. This case

therefore presents no occasion for the Court to address any issues peculiar to the taxation of mutual funds.

As to the taxability of repo interest, the question before the Court is not, as Nebraska contends, primarily a question about the proper *classification* of repurchase agreements as either collateralized loans (on the one hand) or sales and repurchases (on the other). This simplistic approach ignores the diversity of repo terms and conditions, as well as the fact that most repos have attributes of both loans and sales. The central question is not one of characterization but of practical economic reality: whether Nebraska's tax regime adequately preserves the broad and sweeping constitutional immunity of federal obligations from state tax when federal securities are subject to repurchase agreements.

Although the record on this issue is not fully developed, it appears that Nebraska's tax law, when coupled with the tax regimes of other states, improperly reduces the scope of the federal exemption by both disallowing deduction of repo interest to the payor and taxing that interest as income to the recipient. The decision of the Nebraska Supreme Court should thus be affirmed. However, if the Court decides to accept Nebraska's approach and concludes that the instant repo transactions were collateralized loans, we urge the Court to limit its decision to repos with terms and conditions substantially identical to those here.

ARGUMENT

I. IT IS IRRELEVANT TO THE QUESTION BEFORE THIS COURT THAT THE INTEREST RECEIVED BY RESPONDENT PASSED THROUGH A MUTUAL FUND

The question presented in this case is whether a state may tax interest income earned on a repurchase agreement involving federal securities. The initial recipient of the repo interest here was a mutual fund, which passed the interest on to its shareholders, including respondent, in the form of a dividend. But this is not a case about taxation of mutual funds or their distributions; precisely the same question would arise if respondent himself had entered into the repo transaction and received the interest directly. The case therefore presents no occasion for the Court to address any issues peculiar to the taxation of mutual funds.

1. A mutual fund is a type of investment company. Like all investment companies, mutual funds pool their shareholders' money, invest those funds in financial instruments, and distribute their investment income (less expenses) to shareholders. Mutual funds differ from other managed investment companies by virtue of their "open-end" character: there is no limit on the number of shares a mutual fund may issue, and it must redeem its shares upon a shareholder's request.[1]

Although they are usually organized as corporations, mutual funds, unlike regular corporations, function as "passthrough" entities or "conduits" for the

[1] In contrast, shares of "closed-end" funds are fixed in number and are not redeemable for cash, although they are typically traded on an established securities exchange.

passage of investment income to their shareholders. This Court has recognized the conduit nature of mutual funds for securities law purposes, describing them as "pool[s] of assets, consisting primarily of portfolio securities, and belonging to the individual investors holding shares in the fund." *Burks v. Lasker*, 441 U.S. 471, 480 (1979). The federal tax law takes the same approach, endeavoring to place mutual fund shareholders in a position comparable to that of direct investors in the portfolio held by the fund. Under the Internal Revenue Code,[2] a mutual fund that distributes 100% of its taxable income to its shareholders pays no tax at the corporate level, functioning in essence as a conduit rather than as a distinct taxable entity.[3]

The same treatment is also firmly established in state law. Of particular relevance here, all states imposing an individual income tax exempt mutual fund shareholders from taxation on dividends attributable to fund investments in U.S. government obligations.[4]

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[2] Unless otherwise noted, federal statutory references are to the Internal Revenue Code of 1986, 26 U.S.C. ("the Code" or "IRC"), as amended and currently in effect.

[3] Under IRC § 852, mutual funds pay no tax at the corporate level if they qualify as "regulated investment companies" ("RICs") by fulfilling the criteria set forth in IRC § 851(b). RICs that generally distribute at least 90% of their taxable income may deduct those distributions and so will be subject to tax only on the undistributed portion (if any) of their income.

[4] *See* Ala. Admin. Code r. 810-3-14.02(4)(b)(2); Ariz. Income Tax Ruling No. 84-10-5; Ark. Dept. Fin. & Admin. Rev. Policy Stmnt. 1988-5; Cal. Rev. & Tax. Code § 17145; Conn. Gen. Stat. § 12-718; Del. Code Ann. tit. 30, § 1106(b)(1)(ii); D.C. Code Ann. § 47-1803.3(b); Haw. Rev. Stat. § 235-2.3 (adopting IRC §§ 851 and 852 for state tax purposes); Ill. Inc. Tax Info. Bull. Public. 101 and *Andras v. Illinois Dep't of Revenue*, 506 N.E.2d 439 (Ill. App. Ct. 1987), *cert. denied*, 485 U.S. 960 (1988); Ind. Dept. Rev. Info. Bull. No. 79 and *Estate of Kraft v. Indiana Dep't of State Revenue*, Cir. Ct. of Hamilton Co., Ind. (Dec. 2, 1986); Order of the Director in *In re Everett*, Docket No. 84-215-2C-RC, and *Everett v. Iowa*, 470 N.W.2d 13 (Iowa 1991); 8 Ky. Tax Alerts 10 and 11; La. Rev. Stat. Ann. § 47:293(6) and instructions to form IT-540 (Resident Individual Income Tax Return); Md. Admin. Releases Nos. 5 and 11, and *Comptroller of the Treasury v. First United Bank & Trust Co.*, 578 A.2d 192 (Md. 1990); Mass. Gen. L. ch. 62, § 2(a)(2)(A); Mich. Dept. Treas. Rev. Admin. Bull. 1986-3; Minn. R. 8002.0300 subpart 1(A)(2) and *Yurista v. Commissioner*, 460 N.W.2d 24 (Minn. 1990); Miss. Reg. 204; Mo. Code Regs. tit. 12, § 10-2.155(2); Neb. Rev. Stat. § 77-2716(1)(b); N.H. Info. Release TIR 88-001; N.J. Stat. Ann. § 54A:6-14.1; N.M. Income Tax Reg. § 2:10; N.Y. Tax Law § 612(c)(1); N.C. Dept. Rev. Notice (Oct. 4, 1990); N.D. Cent. Code § 57-38-01.2(1)(c)(6); Ohio State Tax Review, Dep't. of Tax., No. 18; Okla. Inc. Tax Rules § 710:50-15-56(b); Or. Rev. Stat. § 316.683; Pa. Stat. Ann., tit. 72, § 7301(f)(II); S.C. Rev. Rul. No. 91-15; Tenn. Code Ann. § 67-2-104(f); Utah Code Ann. § 59-10-114(2)(a) and Utah State Tax Comm'n Tax Bull. 15-19; Vt. Formal Ruling 91-7 and *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); Va. Dep't Tax'n Regs. § 630-2-322(3)(1)(e); W. Va. Emer. Leg. Pers. Inc. Tax Regs., 110 W. Va. Code Regs. 21, § 12.3.2 (1988); Instructions to Form 1, Wis. Indiv. Inc. Tax Return, and *Capital Preservation Fund, Inc. v. Department of Revenue*, No. 86 CV 1385 (Wis. Ct. App. July 21, 1988). Officials from the revenue departments of Colorado, Georgia, Idaho, Kansas, Maine, Montana, and Rhode Island have confirmed in correspondence with the Institute their position that mutual fund distributions attributable to fund investments in U.S. government obligations are exempt from state income tax. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no individual income tax.

This exemption is mandated by the Supremacy Clause and by 31 U.S.C. § 3124, which, as construed by the Court in *American Bank & Trust Co. v. Dallas*

County, 463 U.S. at 862-867, forbids any "direct or indirect" state taxation of federal obligations. Since mutual funds in practice are not separate taxable entities, a state's taxation of shareholders on fund distributions attributable to exempt federal interest would be an impermissible "indirect tax" on that interest. In recognition of this principle, at least 29 states revised their laws after *American Bank & Trust* to make clear that mutual fund shareholders are exempt from taxation on mutual fund dividends attributable to interest on U.S. obligations.[5]

2. The instant case involves a shareholder who received a mutual fund dividend. The tax-exempt status of mutual fund dividends attributable to interest on U.S. obligations, however, is not in dispute as the case comes to this Court. Nebraska is not contending that respondent is taxable on repo interest because that income was distributed to him in the form of a "dividend" from a mutual fund. Rather, Nebraska is contending that repo interest is not tax-exempt to begin with because it is not earned on an "obligation[] of the United States" (31 U.S.C. § 3124(a)). In the

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[5] The states in question were Arizona, Arkansas, California, Connecticut, Delaware, Illinois, Indiana, Iowa, Kentucky, Massachusetts, Maryland, Michigan, Minnesota, Mississippi, Missouri, New Hampshire, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, West Virginia, and Wisconsin. *See, e.g.*, *Brown v. Franchise Tax Bd.*, 197 Cal. App. 3d 300 (1987); *Andras*, 506 N.E.2d 439 (Ill. 1987), *Comptroller of the Treasury*, 578 A.2d 192 (Md. 1990); *Matz v. Department of Treasury*, 401 N.W.2d 62 (Mich. 1986); *Yurista v. Commissioner*, 460 N.W.2d 24 (Minn. 1990); *Borg v. Department of Revenue*, 774 P.2d 1099 (Or. 1989); *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); *Capital Preservation Fund*, 429 N.W.2d 551.

present posture of the case, it is immaterial that respondent is a shareholder in a mutual fund. Nebraska's argument in this Court would be exactly the same if respondent were a bank that received repo interest directly.

The exempt status of such mutual fund dividends, while not now a point of controversy, was at issue earlier in this litigation. Before 1991, the Nebraska Revenue Department attempted to impose a minimum threshold requirement for application of the passthrough principle, ruling in 1987 that tax-exempt federal interest did not pass through from a mutual fund to its shareholders unless 80% or more of the fund's assets were invested in federal securities. Neb. Rev. Rul. 22-87-4, Pet. App. A-32. It was to challenge this ruling that respondent originally commenced this litigation. Pet. App. A-30. The pleadings were subsequently amended to incorporate a separate challenge to Nebraska's position on the taxability of federal repo interest, the sole question now involved here. Pet. App. A-37; Neb. Rev. Rul. 22-85-1. The trial court declared both rulings unconstitutional (Pet. App. A-26, A-28), and Nebraska did not appeal that decision insofar as it invalidated the threshold requirement for application of the passthrough principle. *See* Pet. Br. 5 & n.2. The inapplicability of such a threshold requirement was confirmed in 1991 by statutory amendment. *Ibid.*; *see* 1991 Neb. Laws, LB 773, § 13, *codified at* Neb. Rev. Stat. § 77-2716 (1992).

3. Although Nebraska in this Court properly eschews any challenge to the exempt status of mutual fund dividends reflecting federal interest (Pet. Br. 12

& n.4),[6] several states as *amici curiae* belatedly endeavor to inject this issue into the case. Br. of California *et al.* at 17-22. These *amici* urge the Court to hold that "section 3124's tax exemption cannot be passed through from the mutual fund * * * to its shareholders," even where the fund's dividends indisputably consist of interest on federal obligations. *Id.* at 17-18. In effect, *amici* purport to offer an alternative basis for reversal—that respondent is taxable regardless of the tax-exempt status of repo interest generally because he received that income in the form of a mutual fund "dividend."

Amici's submission should be rejected for three distinct reasons. First, this alternative contention was not presented to the Nebraska Supreme Court and is not properly presented here. As *amici* acknowledge, Nebraska "conceded below that 31 U.S.C. § 3124(a) prohibits taxation of distributions received by respondent as shareholder of a mutual fund to the extent such distributions are traceable to interest on a federal obligation" (Br. of California *et al.* at 17). It is well established that a party in this Court may not urge, as the basis for reversal, an argument not advanced in the court whose judgment is being reviewed. *See, e.g., Kentucky v. Stincer*, 482 U.S. 730, 747 n.22 (1987); *Heckler v. Campbell*, 461 U.S. 458, 468 n.12 (1983); *McGoldrick v. Compagnie Generale Transatlantique*, 309 U.S. 430, 434 (1940); *Blair v. Oesterlein Co.*, 275 U.S. 220, 225 (1927); *Duignan v. United States*, 274 U.S. 195, 200 (1927). Much less

[6] In view of Nebraska's concession on this point, its phrasing of the question presented to include the words "received by shareholders of mutual funds" (Pet. Br. i, 12) is somewhat inaccurate.

should an *amicus* be permitted to advance such an argument when the party it supports explicitly disavows that contention.

Second, *amici*'s alternative argument would not lead to reversal even if it were properly presented here. Since 1991 Nebraska has statutorily mandated full passthrough of exempt federal interest to mutual fund shareholders. *See* page 9, *supra*. Thus, acceptance of *amici*'s submission that passthrough is not constitutionally required would make absolutely no difference to this taxpayer, who is seeking *declaratory* relief. *See* Pet. Br. 5-6 & n.2. *Amici* in effect ask this Court to render an advisory opinion on a subject that is not disputed and—in view of Nebraska's statute—could not possibly be disputed between the parties.

Third, *amici*'s alternative argument is wrong on the merits in any event. As explained previously, mutual funds act as conduits in passing investment income through to their shareholders, placing shareholders in a position comparable to that of direct investors in the fund's portfolio. Thus, state taxation of mutual fund dividends attributable to interest on federal obligations would constitute an "indirect" tax on such interest, which 31 U.S.C. § 3124(a) forbids. *See American Bank & Trust Co.*, 463 U.S. at 862-867. It was precisely in recognition of this fact that 29 states amended their laws after *American Bank & Trust* to confirm that mutual fund shareholders are exempt from state tax in these circumstances. *See* page 8, *supra*.[7]

[7] California and its *amici* assert that mutual fund distributions are simple corporate dividends and thus cannot be immunized

In sum, because Nebraska acknowledges the conduit treatment of mutual funds for tax purposes, the fact that the repo interest passed through a mutual fund is irrelevant to the Court's decision in this case. The Court's decision, of course, will have an ancillary effect on the taxability of mutual fund distributions insofar as it determines the taxability of the mutual fund income from which such distributions are made. But any such effect will be due solely to the fact that mutual funds, like other investors, may invest in repo securities, and not to any status or attributes peculiar to mutual funds *per se*.

II. REPO INTEREST OF THE TYPE RECEIVED BY RESPONDENT IS EXEMPT FROM STATE TAXATION

Following the approach of other state courts that have considered the issue, Nebraska contends that this case presents primarily a question about the proper *classification* of repurchase agreements. Nebraska urges that a repo is "really" a collateralized loan; that the recipient of repo interest is not the "true owner" of the underlying federal securities; and that repo interest therefore enjoys no immunity from state tax. *See* Pet. Br. 8-9, 23-32; Pet. App. A-12. By parity of reasoning, if a repo were "really" a sale and repurchase, the recipient of repo interest would be the "true owner" of the federal securities, and repo interest would presumably be tax exempt. Nebraska urges, in other words, that the tax result follows more or less automatically once the true nature of repurchase agreements is deciphered.

from state taxation by 31 U.S.C. § 3124. This argument, which has been rejected by numerous state courts considering the issue, *see* page 8 n.5, *supra*, ignores this Court's decision in *American Bank & Trust*, the broad scope of the § 3124 exemption, and the unique status of mutual funds as passthrough entities.

The Nebraska Supreme Court declined to follow this simplistic approach, stating: "We do not believe that direct ownership determines whether income from a repo agreement is exempt under [31 U.S.C.] 3124" (Pet. App. A-12). The Institute agrees with that statement. The approach that Nebraska urges in this case ignores the diversity of the repo market and the immense differences among transactions that are labeled "repos." Even if the focus is limited to the specific kind of repurchase agreements involved here, an inquiry into their classification yields no certain or unambiguous result in view of the securities' hybrid nature.

Most importantly, the approach urged by Nebraska asks the wrong question because it ignores the scope and significance of the federal constitutional immunity. The outcome of this case should not turn on the "true nature" of repo transactions in some abstract or recondite sense. The question, rather, is whether state tax regimes like Nebraska's properly preserve—or, as we believe, improperly restrict—the federal exemption when federal securities are subject to repurchase agreements.

A. The Diversity And Scale Of The Repo Market Make Generalizations About Repos Hazardous

Nebraska uses the term "repurchase agreement" as if its meaning coincides with the particular type of transaction before the Court in this case. In actuality, the repo market comprises a large variety of transactions that serve a range of diverse purposes and affect many aspects of our economy. Beyond their

most basic defining features, repos diverge widely in their terms and conditions. Many, if not most, differ significantly from the repos in this case. Therefore, if the Court accepts Nebraska's invitation to make the outcome turn on the proper "classification" of repurchase agreements, we urge that the Court limit its decision to repos with terms and conditions substantially identical to those here.

1. In its most basic form, a repo consists of a sale of securities by a "repo dealer" to a "repo participant" and a concurrent agreement that the repo dealer will repurchase the securities at a later date. A "reverse repo" is the identical transaction viewed from the perspective of the repo participant: the repo participant purchases securities from the repo dealer and agrees later to sell them back. In either case, the stated repurchase price is typically the original sale price plus an additional amount representing the time value of money, *i.e.*, interest.[8] The amount of interest on the repo is unrelated to the interest rate

[8] A comprehensive description of the repo market is contained in Marcia Stigum, *The Repo and Reverse Markets* (1989) [hereinafter Stigum, *Repo Markets*], and Marcia Stigum, *The Money Market* 575-630 (1990) [hereinafter Stigum, *Money Market*]. Other valuable sources include *In re Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557, 566-70, 584-97 (D.N.J. 1986); Alan S. Dunning, *Repurchase and Reverse Repurchase Agreements* (PLI Commercial Law & Practice Course Handbook Series No. 290, 1982); Alan S. Dunning, *Repurchase and Reverse Repurchase Agreements Revisited 1984*, (PLI Commercial Law & Practice Course Handbook Series No. 341, 1984); Dennis E. Logue, *Handbook of Modern Finance* A3-18-A3-20 (1994); Charles M. Lucas, *Federal Funds and Repurchase Agreements*, Fed. Reserve of N.Y. Q. Rev. 33 (Summer 1977) [hereinafter Lucas, *Federal Funds*].

borne by the underlying securities. Instead, the repo interest rate is typically determined by reference to the federal interest rate paid on obligations with a term corresponding to that of the repo. *See* Stigum, *Repo Markets*, *supra*, at 6; *In re Bevill, Bresler*, 67 B.R. at 567.

Repos and reverse repos serve a variety of purposes for a variety of market participants. The Federal Reserve Board uses them to implement monetary policy through the manipulation of bank reserves, especially by offsetting the effects of day-to-day changes in currency circulation. *See* Pet. Br. 15-16; Br. of Federal Reserve Bank of N.Y. ("N.Y. Fed.") at 6-7. Repos are superior to outright purchases and sales for these purposes because of their liquidity and because they do not disrupt market flows the way large volumes of purchases and sales might do. *See* Stigum, *Money Market*, *supra*, at 95-96; *In re Bevill, Bresler*, 67 B.R. at 567. Dealers and investors use repos to finance their portfolios. *See* Pet. Br. 16; Br. of N.Y. Fed. at 4, 6. Banks especially favor them because funds acquired through repos involving federal securities are not subject to reserve requirements. 12 C.F.R. § 204.2(a)(1)(vii)(B).

Reverse repos are used by dealers and investors to obtain securities to deliver to a buyer after entering into a "short" sale. *See* Br. of N.Y. Fed. at 5; Stigum, *Money Market*, *supra*, at 595, 598-600; Lucas, *Federal Funds*, *supra*, at 44. In addition, various investors—including municipalities, mutual funds, pension funds, and banks—use reverse repos as short-term, highly liquid tools for obtaining a respectable yield on funds. For many of these institutions, reverse repos have significant advantages over outright purchases or

loans. *See* Pet. Br. 16; Br. of N.Y. Fed. at 5, 6. Mutual funds and corporations engage in reverse repos to earn interest while maintaining the liquidity necessary to redeem shares or meet payrolls. Banks favor reverse repo transactions involving federal securities because lending limits do not apply to them. 12 C.F.R. § 32.103(a).

2. Given the multiple purposes repos and reverse repos serve and the variety of participants in the repo markets, it is not surprising that repo agreements vary significantly in their terms and conditions. Beyond the basic features (discussed above) common to repos generally, these transactions come in all shapes and sizes. Any type of security can be subject to a repo, although the vast majority of repos involve U.S. Treasury obligations. Repo agreements typically require actual delivery of the securities to the repo participant, usually through the Federal Reserve book entry system; alternatively, they may authorize the repo dealer to hold the securities for the participant's account. Still other repos, known as third-party repos, involve the appointment of the repo dealer's clearing bank as custodian for the repo participant; in such cases, delivery is indicated on the books of the custodian/clearing bank. Most repos are overnight investments or have a term no longer than a few weeks. But they can have set terms as long as a year or be "open." Open repos, also known as "continuing contracts," are indeterminate in length and can be terminated by either party at any time. *See In re Bevill, Bresler*, 67 B.R. at 570; Stigum, *Money Market*, *supra*, at 588; Lucas, *Federal Funds*, *supra*, at 35.

Repos also differ in the rights they accord the dealer and the participant. Dealers of open repos usually

reserve the right to take back particular securities from the repo participant and substitute other securities of the same type and of equal worth in case the dealer needs the original securities before the repo is terminated. Some repo agreements give the repo participant the right to revalue the securities on a daily basis. Thus, if the securities' value falls below a margin built into the sale, the participant may insist that the dealer provide additional securities to make up the difference. *See* Stigum, *Repo Markets*, *supra*, at 188, 217; Stigum, *Money Market*, *supra*, at 588; Lucas, *Federal Funds*, *supra*, at 45.

Finally, the repo participant may or may not have the right to retransfer the securities it purchases from the repo dealer. Some repo agreements prohibit the participant from trading or encumbering the securities unless the dealer defaults. Such limits are the exception rather than the rule, however, as they nullify the purpose of many repos. Investors who enter into reverse repos when creating short sales, for example, must be able to retransfer the securities to purchasers. Dealers in the repo market, as opposed to institutional investors, typically enter into repos and reverse repos not to earn a return on funds, but to earn a spread by purchasing a security as a repo participant and then selling that security as a repo dealer at a slightly lower interest rate. These people would not enter into repo transactions at all if their right to retransfer the securities were restricted. As a result, most repo agreements do not regulate the participant's disposition of the security during the term of the agreement, instead requiring only that he return the security—or in some cases any security

of equivalent value—to the repo dealer on the specified date. *See In re Bevill, Bresler*, 67 B.R. at 570.

3. The repos involved in the instant case represent a particular specimen of the varied species described above. All were reverse repos entered into by mutual funds as a way of earning interest while retaining greater portfolio liquidity and incurring less market (price) risk than would be possible with a direct investment in Treasury securities. The repo dealer was typically a bank or registered broker/dealer, and the securities subject to the repo were long-term Treasury obligations. The standard repurchase agreement executed by the mutual funds (J.A. 65) gave them certain rights protecting their investment, *e.g.*, the right to information about the dealer's financial condition and the right to demand delivery of additional securities should the market decline. J.A. 69-70, 71. But the agreement expressly prohibited the mutual funds from alienating the securities in their possession; unless the dealer defaulted, the funds were barred from reselling or reregistering the securities underlying the repo. J.A. 69. This restriction is relatively uncommon outside the mutual fund arena, and it distinguishes the repos in this case from most other repos. *See* Br. of N.Y. Fed. at 4 & n.3. (noting that repos like the ones involved in this case are "atypical").

The repos at issue here, in light of their atypical terms and limited purpose, do not provide a sound basis for fashioning general rules applicable to all such transactions. Nebraska and its state *amici*, in urging the blanket taxability of all "repo interest," simply ignore the differences among repo transactions. Moreover, the record is devoid of evidence concerning other types of repos, their terms and conditions, and how

they might be affected by the Court's decision in this case. However the Court decides the merits, we urge that it confine its decision to repo transactions substantially identical to those at issue here and avoid fashioning unnecessarily broad rules that could adversely affect segments of the repo market not before the Court.[9]

B. State Tax Regimes Affecting Repo Transactions May Improperly Restrict The Constitutionally-Mandated Immunity Of Federal Obligations From State Taxation

1. Nebraska asks the Court to resolve this case by determining that a repo is in reality a collateralized loan rather than a purchase and sale. Indeed, the state court cases Nebraska cites to support its position all viewed the issue before them as requiring such a determination. Those courts reasoned that only the "true owner" of a federal obligation is entitled to claim an exemption from state tax on the interest received; and that, if a repo is actually a loan, the repo participant is not the "true owner" of the federal securities. *See, e.g., Hammond Lead Products, Inc. v. Indiana Tax Comm'rs*, 575 N.E.2d 998, 1001 (Ind. 1991); *Comptroller of the Treasury*, 578 A.2d at 192, 199-203; *Andras v. Illinois Dep't of Revenue*, 506 N.E.2d at 443-445. Under this approach, the Court's

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[9] As Nebraska recognizes (Pet. Br. 20 n.9), the Internal Revenue Service has declined to adopt blanket rules governing the taxability of all repos, instead fashioning in its rulings on municipal repo interest an approach that considers all the facts and circumstances surrounding the particular transaction in question, analyzing each repo according to its precise terms and conditions. *See* Rev. Rul. 74-27, 1974-1 C.B. 24.

task is basically concluded once the "true nature" of repos is divined.

The Institute believes that the approach Nebraska advocates is neither a useful avenue of inquiry nor the correct mode of constitutional analysis. Repo agreements vary widely. Some are structured to resemble a loan, while others have features more typical of a purchase and sale. But all repos manifest attributes of both. In short, repos are "hybrid transactions which do not fit neatly into either a secured loan or purchase and sale classification." *In re Bevill, Bresler*, 67 B.R. at 597.

The treatment of repos in various regulatory contexts confirms that they are not susceptible to obvious categorization and may be different things for different purposes. For financial accounting purposes, the treatment of repos varies with the nature of the participating entity. Generally accepted accounting principles ("GAAP") require broker/dealers and commercial banks to account for repos as financing transactions—*i.e.*, as loans—whereas state and local governments must record them as purchases and sales. *See In re Bevill, Bresler*, 67 B.R. at 591-592. Federal banking regulations governing lending limits on commercial banks treat a reverse repo as a purchase and resale. *See* 12 C.F.R. § 32.103(a) (purchase of federal securities "subject to an agreement that the seller will repurchase [them] at the end of a stated period is not a loan or extension of credit for purposes of this part") (emphasis omitted). The SEC has issued a policy statement characterizing repos as purchases and sales for most securities law purposes. SEC Exchange Act Release 34-18122, 46 Fed. Reg. 48637 (Oct. 2, 1981). However, with respect to the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, which regulates borrowings by registered investment companies, the SEC considers repos to be secured loans. Investment Company Act Rel. No. 10666, 44 Fed. Reg. 25128, 25129 (Apr. 27, 1979).

In the bankruptcy context repos are explicitly acknowledged to be hybrid instruments. Section 559 of the Bankruptcy Code (11 U.S.C.) suspends application of the automatic stay provisions to repo transactions. Thus, upon a repo dealer's bankruptcy, repo participants may liquidate the underlying securities immediately, as if the transaction entailed an outright purchase. But § 559 also requires any proceeds from the sale of the securities in excess of the agreed repurchase price to be remitted to the bankrupt repo dealer's estate, in recognition of the fact that the transaction also has attributes of a secured loan. *See also In re Bevill, Bresler*, 67 B.R. at 598 (concluding that nonpossessory repos involved in that case were purchases and sales for bankruptcy purposes).

This survey of the varied legal attributes of repos suggests the futility of trying to pigeonhole repo transactions for state tax purposes. *Cf.* Br. of N.Y. Fed. at 4 n.3 (any attempted characterization of repos is "dangerous"). Nebraska's invocation of the doctrine of "form versus substance" (Pet. Br. 9, 17-22) offers no talisman: "substance" is no less important for bankruptcy or securities law purposes than it is for tax purposes. Moreover, to ask whether repos are really secured loans or purchases and sales poses the wrong question. To approach this case as involving a mere matter of classification obscures the true issue, which is not who "owns" the federal obligation, but whether taxation of the interest received by the repo

participant impermissibly encroaches on the constitutional immunity of federal securities from state tax. *Cf.* Br. of N.Y. Fed. at 7.

2. The rule that instrumentalities of the federal government are immune from state and local taxation is grounded in the Supremacy Clause of the Constitution. *See McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819). Since 1862 this rule also has been codified by statute. *See* Act of Feb. 25, 1862, ch. 33, 12 Stat. 345 (1863); Rev. Stat. § 3701 (1878); 31 U.S.C. § 742 (1959). The statute in its current form (31 U.S.C. § 3124(a)), enacted in 1982 without substantive change from its predecessors, provides:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except [a nondiscriminatory franchise tax imposed on a corporation or an estate or inheritance tax].

This provision essentially restates the constitutional rule. *See First National Bank v. Bartow Cty. Tax Assessors*, 470 U.S. 583, 593 (1985); *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983); *New Jersey Realty Title Ins. Co. v. Division of Tax Appeals*, 338 U.S. 665, 672 (1950); *Missouri ex rel. Missouri Ins. Co. v. Gehner*, 281 U.S. 313, 321-322 (1930).

The Court has repeatedly affirmed the breadth of this immunity. It has described § 3124(a) and its predecessors as embodying a "broad" and "sweeping" exemption that is "inconsistent with implied exceptions"

and extends to "every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax." *American Bank & Trust Co.*, 463 U.S. at 864 (emphasis omitted); *Memphis Bank & Trust Co.*, 459 U.S. at 395. In enacting § 3124(a), the Court has stated, "Congress intended to sweep away formal distinctions and to invalidate all taxes measured directly or indirectly by the value of federal obligations." *American Bank & Trust Co.*, 463 U.S. at 867. Nebraska correctly acknowledges the "broad" and "sweeping" nature of the federal exemption (Pet. Br. 34), disavowing its *amici*'s effort to portray the exemption as "narrow" (Br. of California *et al.* at 7).

The test for deciding if a state tax law impinges on this broad exemption is whether the law takes a federal obligation into account, or includes it in the accounting of a state tax, no matter how indirect this "taking into account" may be. *American Bank & Trust Co.*, 463 U.S. at 862-863. Any state tax that "diminish[es] in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit" is invalid under this rule. *Smith v. Davis*, 323 U.S. 111, 117 (1944).

3. Any case involving federal immunity from state taxation presents this Court with a twofold task. The Court must take care that the federal immunity is preserved intact and not compromised or reduced. Conversely, the Court must ensure that the federal immunity is not abused or improperly invoked where the Federal Government's ability to secure credit is not at stake. As it arises here, this task requires the

Court to decide whether the state tax treatment of repurchase agreements involving federal obligations impairs the federal exemption. If that question is answered affirmatively, the state treatment is invalid regardless of how the repo transaction is denominated.

In considering this question, the Court should evaluate how state tax laws treat *both sides* of the repurchase agreement. Both the repo participant and the repo dealer receive interest in the course of the transaction, and both parties have a potential claim that part or all of the interest they receive is exempt from state tax. If the parties in effect divide the exemption between them—such that the aggregate exemption claimed and allowed does not exceed the amount of interest actually paid by the Treasury—there has been no abuse or "double-counting" of the federal immunity from state tax. To the contrary, the exemption in this event has simply been preserved inviolate.

An assessment of how state tax regimes affect repo transactions in their entirety reveals that the treatment urged by Nebraska for the repo participant here, in conjunction with the treatment accorded the repo dealer by Nebraska and (apparently) by most other states, has the effect of improperly reducing the scope of the federal exemption. Most state corporate income taxes begin with the corporation's federal taxable income, then require various upward and downward adjustments to conform with state law. These adjustments invariably permit the corporation to reduce its federal taxable income by interest received

on federal obligations.[10] On the other hand, these adjustments commonly require that interest expense related to receipt of federal interest income, normally deducted for federal tax purposes, be "added back" to income for state tax purposes. To accomplish this result, some states (including Nebraska) have enacted provisions explicitly requiring corporations to add back interest on indebtedness "incurred or continued to purchase or carry" obligations the interest on which is wholly exempt from state tax.[11] Other states achieve the same result with broader provisions requiring the adding back of any expenses allocable to, or related to the production of, tax-exempt income.[12] State in-

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[10] Franchise taxes present an exception to the general rule that federal obligations cannot enter into the calculation of a state tax. *See* 31 U.S.C. § 3124(a)(1). Thus, state franchise tax laws—and equivalent excise or license tax laws—generally do not allow exclusion of federal interest in calculating the corporation's liability. States that have such franchise-type taxes, in lieu of or in addition to a corporate income tax, include California, Idaho, Massachusetts, Michigan, Minnesota, Montana, New Jersey, New York, Tennessee, Texas, Wisconsin, and Wyoming. Nevada and Washington do not tax corporations at all.

[11] *See* Alaska Admin. Code tit. 15, § 20.620(a); Ariz. Rev. Stat. Ann. §§ 43-1121(4), 43-1122(6); Ark. Code Ann. §§ 26-51404(b)(6), (c); Haw. Rev. Stat. § 235-7(a)(1) & (e)(1); Idaho Code § 63-3022(a)(1), (g); Mo. Rev. Stat. §§ 143.431.2, 143.121(a); Neb. Rev. Stat. § 77-2716(1)(a), (b) & (e); N.C. Gen. Stat. § 105-130.5(a)(2), (b)(1), (c)(3); Ohio Rev. Code Ann. § 5733.04(11); Okla. Stat. tit. 23, § 2358(A)(2), Okla. Admin. Code tit. 710, r. 50-17-51(E); Pa. Stat. Ann. tit. 72, § 7401(b), Pa. Rev. Dept. Corp. Tax. Bull. 111, REV-176 CT (8/91); S.C. Code Ann. § 12-7-430(b)(1), (d)(4).

[12] *See, e.g.*, Ala. Code §§ 40-18-34, 40-18-14(2)(d) & 40-18-35(a)(2), Ala. Admin. Code r. 810-3-35.01(d); Cal. Rev. & Tax. Code § 24425, Cal. Regs. tit. 18, § 24271(e)(2)(B); Del. Code Ann. tit. 30, § 1903(a)(2); D.C. Code Ann. §§ 47.1803.2(a)(2)(A),

dividual income taxes generally include similar provisions.[13]

The practical effect of these addback provisions, when coupled with the position of Nebraska (and most other states) on the taxability of the repo participant,[14] is to reduce the scope of the federal exemption. This effect may be illustrated by an example. Assume that a repo dealer holds federal securities that pay $100 of interest, and that those securities are the subject of a repo in which the dealer pays the repo participant $30 of interest. Assume further that the dealer at year-end has federal taxable income of $500, which includes the $100 of federal interest and reflects a $30 deduction for interest paid to the participant. Under state law, the dealer would typically be permitted to reduce its federal taxable income by the $100 of federal interest, but it would also be

47.1803.3(d)(6)(A); Ga. Code Ann. § 48-7-21(b)(1)(B); Kan. Stat. Ann. §§ 79-32, 79-138(c)(i) & 79-117(c)(i); Ky. Rev. Stat. Ann. § 141.010(12)(a) & (13)(d); La. Rev. Stat. Ann. §§ 47:287.71(B)(1) & 47:287.81; Minn. Stat. § 290.10; Miss. Code Ann. §§ 27-7-15(4)(d) & 27-7-17(1)(b); N.M. Stat. Ann. § 7-2A-2(I)(2); Wis. Stat. § 71.26(3)(b) & (*l*).

[13] *E.g.*, Cal. Rev. & Tax. Code §§ 17270, 17280(b)(2); Conn. Gen. Stat. § 12-701(a)(2)(A)(vii), (b)(i); D.C. Code Ann. § 47-1803.3(d)(6)(A); Ga. Code Ann. § 48-7-27(b)(2); Ky. Rev. Stat. Ann. § 141.010(11); Mass. Gen. L. ch. 62, § 2(d)(1)(B); Minn. Stat. § 290.10; Neb. Rev. Stat. § 77-2716(1)(e); N.Y. Tax Law § 612(b)(4); Pa. Dept. Rev. Regs., tit. 61, § 103.16(a); R.I. Gen. Laws § 44-30-12(c)(1); S.C. Code Ann. § 12-7-430; Va. Dep't Tax'n Regs. § 630-2-322(3)(1)(f); Wis. Stat. § 71.05(6)(b)(1).

[14] All States now appear to treat federal repo interest as taxable, either according to administrative practice or under statute or regulation. *Cf.* Br. of the Council of State Governments *et al.* at ii n.*.

required to "add back" the $30 of interest paid to the repo participant, yielding state taxable income of $430.

In this example, it seems clear that only $70 of the dealer's income—the *net* interest income he derives from the repo transaction—enjoys any exemption from state tax. If, as Nebraska contends, the repo participant is fully taxable on the $30 of interest it receives, the federal exemption has been improperly reduced. Although the federal securities underlying the repo pay $100 of interest that is indisputably exempt from state tax, the repo participant and the repo dealer together enjoy an exemption of only $70. The federal exemption, in other words, has "shrunk" by 30%, for no reason other than that the federal securities have been the subject of a repurchase agreement.

The record in this case is virtually silent as to the tax treatment that various states accord repo dealers in repurchase transactions. Although this is basically a legal inquiry, state laws on the subject are often less explicit than might be wished, and the treatment may sometimes depend on state tax authorities' actual audit practice. If the Court agrees with our submission that the tax treatment of both sides of the repo transaction is relevant in deciding the question presented here, the Court may wish to await another case in which the record is more fully developed, and dismiss the instant petition as improvidently granted. Alternatively, if the Court concludes that the practice of the other states is sufficiently clear—or that the question can be answered by reference to Nebraska's practice alone—it should affirm the decision of the Nebraska Supreme Court.[15]

[15] California and its *amici* argue alternatively that, if a repo

C. Precedents Concerning The Federal Tax Treatment Of Interest Received On Repos Involving Municipal Bonds Are Inapposite Here

On two prior occasions, federal courts have held that interest received by municipal bond repo participants is subject to federal income tax notwithstanding IRC § 103(a)(1), which exempts from tax interest on state and local bonds. The rationale of these decisions was that the repos were really collateralized loans, and that the § 103(a)(1) exemption applies only to the "owner" of the bonds. See *Union Planters National Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970); *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970). The Fifth Circuit did not address the impact of IRC § 265(a)(2), which, like the state tax provisions discussed earlier, denies a deduction for "interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt" from tax. The Sixth Circuit did discuss that provision, concluding that treatment of the repo transaction as a purchase and sale would enable the parties "to enjoy the benefit of the double tax advantage which Congress intended to prevent" (426 F.2d at 116).

This Court has never considered the appropriate treatment of municipal bond repo interest. But even

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is really a sale/repurchase, the income is not interest but taxable capital gain. Br. of California *et al.* at 13. This argument is meritless. It is absolutely clear that the difference between the sale and repurchase prices for the security underlying the repo is 100% attributable to the time value of money. For that reason, the differential constitutes interest for tax purposes, just as in the case of obligations issued at a discount. *See, e.g.*, Treas. Reg. § 1.61-7(c).

if one assumes that these two appellate decisions are correct, they do not justify parallel treatment of federal repo interest. Section 103 of the Code embodies no constitutional requirement; as a statutory exemption from federal tax, it is, like other exemptions and deductions, a matter of legislative grace. *See South Carolina v. Baker*, 485 U.S. 505, 524 (1988). Congress may thus limit and define the exemption for municipal bond interest as it sees fit. And since the exemption is intended as an incentive for taxpayers to invest in local government, it is not unreasonable to assume that Congress intended its benefits to inure only to taxpayers who actually "incur[] the risk that ownership of municipal bonds entails." *American National Bank of Austin*, 421 F.2d at 451.

The states have no such latitude to define the immunity of federal obligations from state tax. That immunity, while codified by statute, is constitutionally grounded; it is not a product of the states' largesse. The Supremacy Clause dictates the immunity of federal obligations from state taxation in order to ensure the Federal Government's ability to secure credit, a purpose vastly different from simply encouraging private individuals to invest in local government. *See Smith*, 323 U.S. at 115-119. Whereas limiting an exemption to the "actual owner" of the security might be a reasonable way of achieving the latter goal, ownership is far less relevant when the question is whether a state tax diminishes the attractiveness of the federal securities market, or whether a constitutionally mandated immunity is compromised by state laws that deny both an exemption for repo interest income and a deduction for repo interest payments.[16]

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[16] California and its *amici* suggest that any difference in the

CONCLUSION

The decision of the Nebraska Supreme Court should be affirmed. Alternatively, the Court may wish to dismiss the petition for writ of certiorari as improvidently granted.

Respectfully submitted.

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tax treatment of municipal and federal repo interest would constitute impermissible discrimination against state obligations in favor of federal obligations, in violation of the principles of intergovernmental tax immunity. Br. of California *et al.* at 23. This argument assumes that the protection this doctrine offers the federal government against state discrimination in favor of state obligations is precisely identical to the protection it offers states against federal discrimination in favor of federal obligations. *Amici* cite no cases in support of this proposition. In any event, the federal taxability of municipal repo interest is not now before, and has never been before, this Court. Any argument about impermissible "discrimination" is thus an issue for another case.